



REPORT OF EXAMINATION

PEMCO MUTUAL INSURANCE COMPANY

As of December 31, 1997 and 1998

CHIEF EXAMINER'S AFFIDAVIT

I hereby certify I have read the attached Report of the Financial Examination of the PEMCO MUTUAL INSURANCE COMPANY of Seattle, Washington. This report shows the financial condition and related corporate matters as of December 31, 1998.

A handwritten signature in black ink, reading "Patrick H. McNaughton". The signature is written in a cursive style with a large initial "P" and a long horizontal stroke at the end.

Patrick H. McNaughton, Chief Examiner

PEMCO MUTUAL INSURANCE COMPANY
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Seattle, Washington
October 24, 2002

The Honorable Alfred W. Gross
Commissioner, Commonwealth of Virginia
Bureau of Insurance
Chair, NAIC Financial Condition Committee
PO Box 1157
Richmond, VA 23218

The Honorable Merwin Stewart
Commissioner, Utah Department of Insurance
NAIC Secretary, Western Zone
3110 State Office Building
Salt Lake City, UT 84114-1201

The Honorable Mike Kreidler
Insurance Commissioner, State of Washington
PO Box 40255
Olympia, WA 98504-0255

Dear Commissioners:

In accordance with your instructions and in compliance with the statutes of the state of Washington, Chapter 48.03 Revised Code of Washington, an Examination has been made of the corporate affairs and financial records of the

PEMCO MUTUAL INSURANCE COMPANY
of
Seattle, Washington

hereinafter referred to as the Company, at its home office located at 325 Eastlake Avenue East, Seattle, Washington 98109-5466. The following report on the examination is respectfully submitted showing the condition of the Company as of December 31, 1997 and 1998.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 1992. The current examination conducted by insurance examiners from the state of Washington and covered the period from January 1, 1993 through December 31, 1998. The examination was conducted in accordance with the laws and regulations of the state of Washington contained in Title 48 of the Revised Code of Washington (RCW), Title 284 of the Washington Administrative Code (WAC), and the examination procedures recommended by the National Association of Insurance Commissioners found in the NAIC Financial Condition Examiner's Handbook.

Corporate records and various aspects of the Company's operating procedures and financial records were reviewed and tested during the course of this examination and are commented upon in the following sections of this report. The Company's certified public accountant's work papers were reviewed and utilized where possible to support efficiency in the examination.

INSTRUCTIONS

Pursuant to the findings and conclusions of the examiners and actuary, in accordance with sound actuarial principals, Title 48 RCW, Title 284 WAC and the NAIC Accounting Practices and Procedures Manual (APPM) for property and casualty insurance companies, the Company is hereby instructed to comply with the following:

1. **THE COMPANY IS INSTRUCTED** to comply with **WAC 284-02-080** and file all amendments to its bylaws with the insurance commissioner. Reference "CORPORATE RECORDS" (page 6).
2. **THE COMPANY IS INSTRUCTED** to comply with **WAC 284-07-050(2)** which requires adherence to the appropriate Annual Statement Instructions and the Accounting Practices and Procedures Manuals promulgated by the NAIC for the completion of the annual statement. **RCW 48.05.250** requires the Company to file with the insurance commissioner a true annual statement of its financial condition, transactions, and affairs. Reference "CORPORATE RECORDS" (page 6), "REINSURANCE PROGRAM" (page 11) and "NOTES AND COMMENTS TO FINANCIAL STATEMENTS – 1" (page 20).
3. **THE COMPANY IS INSTRUCTED** to comply with **RCW 48.12.010** and report as allowable assets only those assets that belong wholly and exclusively to the insurer, which are registered, recorded, or held under the insurer's name. Reference "NOTES AND COMMENTS TO FINANCIAL STATEMENTS – 1" (page 20).
4. **THE COMPANY IS INSTRUCTED** to comply with **RCW 48.13.340 and 350** that require Board of Director written approval in permanent form. Reference "NOTES AND COMMENTS TO FINANCIAL STATEMENTS – 3" (page 20).

HISTORY

PEMCO Mutual Insurance Company (PMIC) was organized as a mutual insurer in the state of Washington during October 1948 and commenced business during February 1949 under the name, Public Employees Mutual Insurance Company. During January 1977, pursuant to RCW 48.31.010, the merger of Public Employees Mutual Casualty Company into Public Employees Mutual Insurance Company was approved. The name was later changed to PEMCO Mutual Insurance Company during January 1989. The Company is licensed to operate only in the state of Washington and writes multiple-lines property and casualty coverage for the general public. PMIC is the ultimate controlling entity in the Insurance Holding Company System.

CAPITALIZATION:

The Company is incorporated as a mutual insurance company that is owned by and operated in the interest of its members per RCW 48.09.110 and 120. As a mutual insurer, there is no authorized or issued capital stock. RCW 48.09.100 requires a domestic mutual insurer to maintain surplus funds that represent the excess of its assets over its liabilities in an amount not less than that stated in RCW 48.05.340 for the lines of business that it authorized to transact. The Company meets those requirements.

POLICY HOLDERS DIVIDEND DISTRIBUTIONS:

There have been no policyholders' dividends declared or paid during the six year examination period, January 1, 1993 through December 31, 1998.

AFFILIATED INSURANCE COMPANIES

PEMCO Corporation (CORP) is a stock company that was incorporated in the state of Washington during April 1963.

CORP currently provides data processing services, and leases automobiles and office equipment to the three insurance companies, the Public Employees Insurance Agency and the other companies under common management. The services are purchased per agreement.

PEMCO Life Insurance Company (PLIC) is a Washington corporation organized as a stock insurance company on May 27, 1963. The Company's Certificate of Authority was issued on June 11, 1963 and authorized the business of life and disability insurance. The Company is also authorized to write participating or non-participating insurance coverages. The Company is a wholly owned subsidiary of PEMCO Corporation.

PEMCO Insurance Company (PIC) was incorporated on May 4, 1972, as a stock multiple line property and casualty insurance company under the laws of the state of Washington. PIC is licensed to operate only in the state of Washington. The Company's Certificate of Authority was issued on August 22, 1972 and authorized the business of property, vehicle, casualty and surety insurance.

NON-INSURANCE COMPANIES UNDER COMMON MANAGEMENT

Public Employees Insurance Agency (The Agency) is a stock company incorporated in the state of Washington during October 1968. The Agency sells insurance and collects premium on behalf of the affiliated insurance companies.

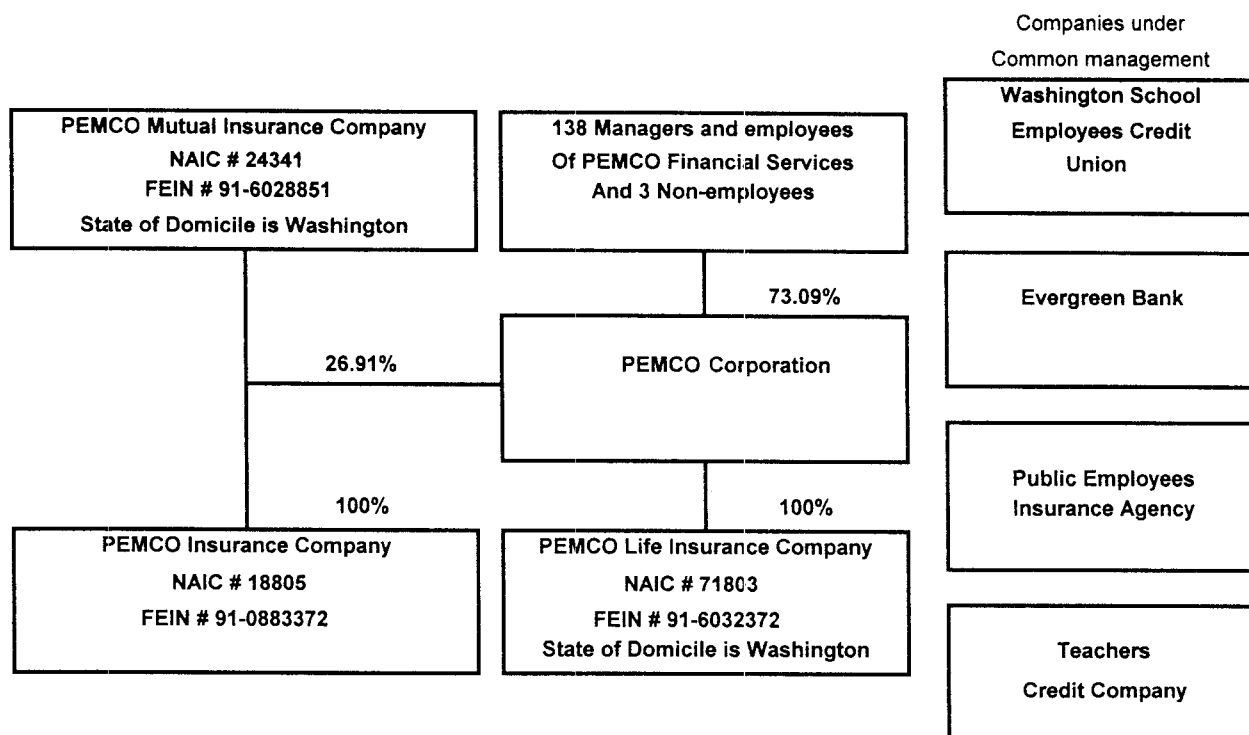
Washington School Employees Credit Union (WSECU) was founded by Robert J. Handy and a group of educators in 1936. Today, the Credit Union is one of the largest members owned credit unions in the state with more than 63,000 members, serving school employees and their relatives who live in Washington.

Evergreen Bank (EB), formerly Teachers State Bank, was incorporated under the laws of the state of Washington on December 28, 1970 and commenced business on October 1, 1971. EB provides banking services for all affiliated companies more than 8,200 other businesses and individual customers. EB has offices in Lynnwood and Seattle and they provide a wide range of products and services, including deposit accounts, loans, and investments.

Teachers Credit Company (TCC) was incorporated under the laws of the state of Washington during 1941. TCC retains and exercises the proxy votes of the policy holder members of the mutual company, PMIC.

ORGANIZATIONAL CHART

The following organizational chart displays the relationship of all of the affiliates under the PEMCO holding company system and other non-insurance companies under common management.



Note: The affiliated companies under the holding company system do not have any ownership interest in the companies listed under common management, other than PMIC owning 22,000 shares (3.3%) and PIC owning 10,000 shares (1.5%) of Evergreen Bank common stock.

MANAGEMENT and CONTROL

The Company is owned by and operated in the interest of its members per RCW 48.09.110 and 120. The bylaws provide that each policyholder is a member of the Company and that members shall meet on January 3rd of each year for the purpose of receiving reports of the Company's affairs and to fill vacancies existing on the Board of Directors. Each member has one vote that may be exercised in person or by a proxy. Each member's insurance contract specifies the procedure for appointing a proxy.

BOARD OF DIRECTORS:

Control of the Company is vested in the Board of Directors (BOD) consisting of nine (9) members as of December 31, 1998. Three board members are elected at each annual policyholders meeting for a three year term.

<u>Name and Address</u>	<u>Principal Business Affiliation</u>	<u>Member Since</u>
Stan William McNaughton	President and Chief Operating Officer BOD, PMIC, PIC and PLIC	1998
Richard Stanley White	Secretary BOD, PMIC and PIC	1971
Ed Kenneth Erickson	Chairman of the Board BOD, PMIC and PIC	1967
Carl Elmer Tingelstad	BOD, PMIC and PIC	1978
Mary Henriette Johnson	BOD, PMIC and PIC	1973
Sandra May Kurack	BOD, PMIC and PIC	1989
Shirley Liu Hodgson	BOD, PMIC and PIC	1985
Robert Dean Sealey	BOD, PMIC and PIC	1971
Borge Osvald Saxberg	BOD, PMIC and PIC	1996

OFFICERS:

Officers are elected at the annual Board of Directors' meeting for a one-year term. Officers on December 31, 1998 were:

Stan William McNaughton	President and Chief Operating Officer
Richard Stanley White	Secretary
Robert William Howisey	Vice President and Treasurer
Charles Irwin Palmerton	Vice President
Ed Kenneth Erickson	Vice President

COMMITTEES:

PEMCO Mutual Insurance Company's corporate bylaws provide that the Board of Directors shall designate an Executive committee at its first regular meeting of each year. Additionally, the BOD shall have the authority to appoint such additional standing or temporary committees as the BOD may deem necessary. Active committees during the period of examination were the Executive Committee, the Investment Committee, a Proxy Committee and a Nominating Committee. Committee reports were routinely submitted to the BOD for review and approval where applicable.

CORPORATE RECORDS:

The initial **Articles of Incorporation** were adopted by the Board of Directors September 7, 1948. There have been four amendments since organization. The last time was during 1989 when Article II was amended, changing the name of the Company to PEMCO Mutual Insurance Company. No amendments have been made to the Articles of Incorporation during the period of this examination or in the subsequent two-year period, 1999 and 2000. The initial Articles of Incorporation and all amendments were authorized by the Board of Directors and filed with the state of Washington in accordance with the Washington Insurance Code.

The **corporate bylaws** have been amended eight times since the original bylaws were adopted in 1949. The corporate bylaws have been restated twice, once on November 16, 1972 and most recently, subsequent to the examination date, on February 23, 2000.

The seventh and eighth amendments were made during the period of this examination. On October 16, 1995, Article VI, Funds and Checks, Sections 1 and 2, were amended to add the phrase, "or electronic fund transfers" to modify the words "check" or "checks" wherever they appear. A new article section 3b, regarding compensation of directors and officers was added to Article IV, Section 3 on April 15, 1977.

The Board of Directors authorized all changes to the corporate bylaws. However, none of the amendments were filed with the Insurance Commissioner as required by **WAC 284-02-080(8)** (see Instruction 1). In addition, the general interrogatory question in the annual statements for each of the respective years, "Has any change been made during the year of this statement in the charter, by-laws, articles of incorporation, or deed of settlement of the company?", was answered, "No". **RCW 48.05.250** requires an annual statement without errors (see Instruction 2).

All of the annual policyholders meetings were held in January of each year as prescribed in Article I, Section 2 of the corporate bylaws. The primary business was the election of three new members to the Board of Directors for a three year term.

The minutes of all Board of Directors' meetings held during the examination period (January 1, 1993 through December 31, 1998) and the subsequent two year period, 1999 and 2000, were reviewed for significant subject matter, an indication of member activity and participation. Board of Director activity was also reviewed with consideration for compliance with the Washington Insurance Code and compliance with the Company's Articles of Incorporation and Bylaws.

The Board of Directors meets every month throughout each year and calls special meetings when necessary. The annual meeting of the Board of Directors is held each year immediately following the annual meeting of the policyholders. At this meeting, the Board of Directors elect its officers for the ensuing year and the Executive Committee is designated.

The Board of Directors was active throughout the examination period. Meetings were well attended and the minutes were in sufficient detail and substance to demonstrate that the Board of Directors' members were actively involved in the administration of the affairs of the Company. All meetings were documented in written form, noting items of discussion and specific actions taken.

AGREEMENTS

The Company is a participant in several agreements among affiliates and, as a member of an insurance company holding system, these have been filed pursuant to RCW 48.31B.025. As of December 31, 1998, the Company was party to the following agreements:

Cost Sharing Agreements: The affiliated companies have extensive cost sharing activities among themselves. PEMCO Mutual Insurance Company owns the real estate occupied by the affiliated companies and leases specified space to the affiliated companies per periodic amendments to the Agreement of Lease. PMIC from time to time also procures products, supplies, and services on behalf of the affiliated companies.

PEMCO Corporation, per agreement, provides data processing services, and leases automobiles and office equipment to the three insurance companies, the Public Employees Insurance Agency, and the other non-insurance companies under common management.

PMIC pays certain shared general expenses that benefit all of the affiliated companies. Reimbursement for products, supplies, and services is subject to a general "Reimbursement Agreement" dated January 1, 1990. Allocations are based on actual benefits received or by the same head count data that is used to allocate the expenses of the Supplemental Pension Fund. Affiliates are billed and reimburse PMIC on a monthly basis.

PMIC pays all expenses for PIC. PMIC is totally responsible for all non-auto line of business expense. All auto line of business expense is allocated between PMIC and PIC based upon a ratio of in-force policy counts at December 31st of the prior year. PIC reimburses PMIC for its share of expenses on a monthly basis.

Other ad hoc expense allocations occur based on specific contract or usage. A specific contract can be for a project, product, or service and is allocated based on an agreed percentage between two or more of the affiliated companies. Specific usage relates to vendor invoices that include goods or services that have been ordered by two or more of the affiliated companies, but is on one invoice. The affiliated company paying the invoice is reimbursed by the other affiliated companies on a monthly basis.

The following cost sharing agreements were in effect as of the examination date:

- Reimbursement Agreement (products, supplies and services)
- Lease Agreement (office space)
- Computer Service Agreement (software development and maintenance)
- Consulting Service Agreement (special projects)
- Master Equipment Lease Agreement (auto, computers, furniture and other equipment)

Officers of each company signed the agreements, and procedures and guidelines followed by the company indicate that expenses were equitably distributed with no affiliated company gaining an undue advantage because of inappropriate expense allocation. There were no other

agreements that would indicate a material contingent exposure to the Company's assets. Settlement among the affiliates was on a monthly basis.

Tax Allocation Agreement: The Company files a consolidated federal income tax return with its wholly owned subsidiary, PEMCO Insurance Company. The method of allocation between the companies is subject to an agreement approved by the Board of Directors. Allocation is based upon separate return calculations with current credit for net losses. PMIC periodically pays the IRS estimated taxes for both companies and PIC reimburses PMIC for its estimated portion through the affiliated company receivable/payable account within fifteen days after month end closing. The final inter-company tax balances are settled annually during the filing quarter.

General Agency Contract: There is a general agency contract between the Company and the Public Employees Insurance Agency. This is a continuation of the October 4, 1948 General Agency Contract between the late Robert J. Handy, Public Employees Mutual Casualty Company, and Public Employees Mutual Insurance Company. The General Agency Contract was purchased from Mr. Handy by Public Employees Insurance Agency effective October 1, 1968. The five grandchildren of Robert J. Handy and the five children of Stanley O. McNaughton own the Public Employees Insurance Agency.

During 1998, a suit was filed against the Company by minority shareholders of Public Employees Insurance Agency, Inc. The Agency has been managed by persons who have simultaneously served as directors and officers of the Company. The suit claims that the Agency has been operated so as to unfairly benefit the Company and asks for damages in an unspecified amount. See "Subsequent Events" (page 12).

Agency Agreement: An Agency Agreement between the Company, the Public Employees Insurance Agency, and the agent was written and effective September 1, 1985. The essence of this agreement outlines how premiums are collected and forwarded to the Company, the payment of commissions and other expenses, and how profits are shared.

Insurance Agreement: PMIC has agreed to insure PLIC against the loss of unassigned surplus for the amount of surplus loss exceeding \$500,000 as of December 31st in any year up to a maximum liability of \$500,000. The annual premium is one per cent of the total gross income as shown on page 4, line 7, column 1 of the PLIC annual statement. Premiums are paid quarterly based upon gross income for each calendar quarter and adjusted, if necessary after completion of the Annual Statement.

INTERNAL SECURITY

Custodial Agreements: PEMCO Mutual Insurance Company security custodial agreements have been appropriately executed and contain the appropriate language set forth in the NAIC Financial Examiners Handbook.

Conflict of Interest and Confidentiality Policy: The affiliated companies have a combined Conflict of Interest and Confidentiality Policy which requires the annual completion of a Conflict of Interest Statement by officers, directors, and key employees. All are required to disclose to the President, Chairman, or Board of Directors of the appropriate company, relevant outside interests, memberships, associations, and affiliations. All appropriate persons have complied with this policy. Conflict of Interest and Confidentiality Policy information is periodically discussed by and noted in the PMIC and PIC Board of Directors' joint meeting minutes.

The policy and the indicated activity by the affiliated companies demonstrate that the Company takes great effort to protect the confidentiality of the Company strategy, all records, data and any other information of a private or sensitive nature. No conflicts have been disclosed that would indicate a failure to give an undivided and unselfish loyalty to the company which demands that there be no conflict between corporate duties and self-interest.

Fidelity Bond and Other Insurance: A fidelity insurance policy is purchased by PEMCO Mutual Insurance Company and covers the affiliated companies. Coverage limits to \$5,000,000 are provided for all of the affiliated companies insured. The minimum amount recommended by the NAIC is \$1,500,000. The aggregate amount of coverage appears adequate to cover the exposure risk of the Company and its affiliates.

The Company is also provided protection against certain property and liability losses as a named insured on other policies obtained by PMIC. Policies in effect at December 31, 1998 provided coverages for real and personal property, commercial general liability, umbrella/excess liability, insurance agents/brokers professional liability, financial institution fidelity bond, fiduciary liability, directors & officers liability, errors & omissions liability.

EMPLOYEES' BENEFIT PLANS

All employees of the affiliated companies are eligible to participate in certain affiliated company sponsored insurance programs and benefit plans on the first of the month following an introductory period. Programs and eligibility vary according to employee status. Each company pays its own employees' salary and associated benefits.

The Company offers the following benefits: medical insurance, a dental assistance plan, long-term disability insurance, long-term care insurance, life insurance, optional life insurance, retiree medical, dental and other benefits.

The Company offers a 401(k) Savings and Profit Sharing Plan. This is a defined contribution plan where the employer pays eligible employees for their contributions to the continued success of the Company. One to ten percent of pay may be contributed to the plan with immediate 100% vesting. The Company contributes 200 percent matching on the first 6% of the employee contribution. Additional discretionary Company contributions may be made at the end of each year. After three years of service, the Company contributions are 30% vested and become fully vested after seven years of service. There are several options for withdrawal.

The Company also offers the usual options for time off from work including personal days, vacation, sick leave and the traditional holidays.

TERRITORY AND PLAN OF OPERATION

PEMCO Mutual Insurance Company is authorized to transact property, vehicle, general casualty, marine and transportation, and surety business in the state of Washington.

The Company operates on a cash premium plan of insurance. The Public Employees Insurance Agency, Inc., operates as an exclusive general agent authorized to transact insurance business for the Company. On December 31, 1998, there were 190 agents licensed and appointed to transact business for the Company.

The Company has a branch office in Spokane, Washington and a satellite processing center in Lynnwood, Washington. Claim branch service offices are located in Tacoma and Yakima,

Washington. The Company also has five smaller drive-in offices throughout the state that settle small property damage claims. The majority of claims are handled directly through its home office on a twenty-four hour basis.

The Company uses staff adjusters in the settlement of claims. Independent adjusters are used in areas not serviced by Company personnel.

REINSURANCE PROGRAM

The Company has five reinsurance contracts in place as of December 31, 1998, all of which name both PMIC and PIC as the ceding companies. The assuming companies are all rated A or better by AM Best. The agreements cover all the property and casualty lines of business written by PMIC and PIC. Retention levels vary by agreement.

There are two facultative agreements which bind the reinsurer on a per policy basis.

The more significant of the two agreements is a quota share personal excess liability automatic facultative agreement. The agreement provides 90% reinsurance for the first \$1,000,000 in coverage and 100% reinsurance for coverage over \$1,000,000, up to a \$3,000,000 limit in coverage. This provides the Company with a 10% retention per policy. The main source of revenue for these policies is from a 30% flat commission rate which it charges the reinsurer for each policy written.

The second facultative agreement is a home surplus line which covers fire, allied lines, homeowners multiple peril, farmowners, commercial and earthquake. The agreement provides coverages in excess of \$700,000 and allows the Company to cede up to 70% of the amount retained by the Company up to \$500,000. The Company pays 100% of the premiums for the ceded insurance and receives a 22.5% commission.

There were three treaty agreements in effect during 1998 which are based upon earned premiums. The reinsurer agrees to share a portion of the premium and expense on risks that have already been bound and are in force. The reinsurer does not retain the right to refuse coverage on a policy by policy basis.

One treaty agreement provides casualty excess of loss reinsurance covering major perils liability. The policy is structured on an incurred basis. In the years prior to 1996 the agreement detailed three layers, but that was reduced to two layers for 1996 and 1997. On December 15, 1997, these two layers were changed to one layer retroactive to January 1, 1997. The premium rate was originally .35% and .17% for the two layers effective January 1, 1996. The rate for the retroactive change was .40% of earned premiums. The agreement during 1998 and 1999 was in a single layer, reinsuring 100% of losses up to \$4,500,000 in excess of \$500,000 per occurrence. The premium rate for 1998 and 1999 was 28%.

A second treaty agreement provides property per risk excess of loss reinsurance covering major perils fire and allied lines business written by PMIC, except those lines specifically excluded in Article II of the agreement. The agreement provides for two layers of coverage, with the exception of watercraft. Private pleasure watercraft policies are reinsured 100% for amounts in excess of \$75,000 subject to limits of \$125,000 of each loss, per risk, per occurrence. The first layer for all other risks reinsures 100% of \$375,000 in excess of \$125,000 per risk, per occurrence and \$1,125,000 for all risks involved in each occurrence. The second layer provides 100% reinsurance for losses in excess of \$500,000 subject to a maximum limit of

\$200,000 per risk, per occurrence and \$600,000 for all risks involved in each occurrence. The reinsurance premiums for the first and second layer are 6.3% and .322%, respectively.

The third treaty agreement is a property catastrophe excess of loss reinsurance agreement involving fourteen participants. The major participant, consisting of Lloyd's Syndicates, is obligated for 60% of the interests and liabilities set forth under the agreement. The cover is 90% of \$200,000,000 excess \$50,000,000 each and every loss occurrence. The premium rate was 6.45% of gross net earned premium income.

Reinsurance agreements were reviewed for compliance with Washington State reinsurance statutes. The contracts have the standard insolvency clause wording required by the Washington Insurance Code to minimize the Company risk. Three participants in the property catastrophe excess of loss reinsurance agreement are unauthorized reinsurers in the state of Washington. Their combined participation is 11% or \$557,000 in ceded premiums.

The Annual Statement Schedule F, Part 3 for the year ended December 31, 1998, improperly reflects these unauthorized reinsurers as "Authorized – Other Non-U.S. Insurers." Schedule F, Part 5 does not reflect a calculation for "Provision for Unauthorized Reinsurance" for these reinsurers. However, a calculation would show that no provision for unauthorized reinsurance would be required. (see Instruction 2)

The President and the Vice President routinely review the reinsurance program to be sure that the exposure to risk is limited by spreading that risk through the various reinsurance contracts. Based upon our review, the Company appears to be adequately monitoring its reinsurance program and the overall reinsurance program appears to be adequate for the Company's exposure and ability to assume risk.

INFORMATION SYSTEMS AND ACCOUNTING RECORDS

PEMCO Corporation provides all of the affiliated companies with EDP services. The management of CORP is sufficiently knowledgeable of EDP issues and the various department managers work with the IS Department to provide direction and oversight. Systems development, acquisition, and maintenance controls were evaluated to gain assurance that programs and systems are designed, tested, approved, and implemented using appropriate controls. The Company has detailed written documentation for its major operations and financially significant applications, proper supervision and review for each project to ensure satisfactory completion, and an Internal Audit Department that includes an EDP specialist.

Operations, processing, and documentation controls were reviewed to determine the type of hardware installed; operating systems and proprietary software in use; back up and recovery facilities employed; and the controls exercised to maintain data security. Adequate procedures and controls are in place for its mainframe operations and PC's.

The Company has also prepared a detailed written contingency plan to ensure its ability to service the needs of its policyholders in the event of any unforeseen circumstances.

ACTUARIAL

The casualty actuarial staff employed by the Office of Insurance Commissioner, state of Washington, performed the actuarial review of the Company's reserves. The Company provided loss and loss adjustment expense development data by accident year and sub-line.

The actuarial staff obtained additional information by interviewing several Company employees. They also reviewed an actuarial report prepared by the Company's consulting actuarial firm.

The reserves carried by the Company for the unpaid losses and loss adjustment expenses were \$81,344,970 and \$19,779,344, respectively, as of December 31, 1998.

The actuarial staff's estimates indicate that the reserves for both losses and loss adjustment expenses, on a net basis, are within a reasonable range. Therefore, these reserves are accepted as they appear in the Company's 1998 annual statement.

SUBSEQUENT EVENTS

Ownership and Control: There have been no changes in ownership and control of the Company. However, during the subsequent years to the examination date, there were changes within the holding company system.

PEMCO Corporation separated into two separate companies effective July 1, 2000. CORP remains the owner of PLIC and continues to focus on computing services. The new company, PEMCO Technology Services, will concentrate on electronic transaction processing (formerly called PowerLink).

PEMCO Insurance Agency: On May 19, 2000, the Company acquired the outstanding shares of the Public Employees Insurance Agency, Incorporated (the "Agency") for approximately \$6,496,000. The Agency was previously owned by individuals and provided insurance agency services to the Company for commissions and reimbursement of substantially all operating costs. This acquisition resolves previous litigation matters between the Company and the Agency's minority shareholders. A premium payment was made in addition to the purchase price and has been recorded as a surplus adjustment rather than a charge to operations under GAAP accounting, and reflected as a surplus contingency reserve at December 31, 1999, as permitted by the Office of Insurance Commissioner.

FINANCIAL STATEMENTS

The following statements reflect the financial condition of the Company as of December 31, 1998, as determined by this examination:

Balance Sheet
As of December 31, 1998

Comparative Balance Sheet
As of December 31, 1997 and 1998

Statement of Income
Year Ended December 31, 1998

Comparative Statement of Income
For the Years Ended December 31, 1997 and 1998

Capital and Surplus Account
As of December 31, 1998

Comparative Capital and Surplus Account
Years Ended December 31, 1997 through 1998

PEMCO MUTUAL INSURANCE COMPANY

BALANCE SHEET AS OF DECEMBER 31, 1998

	BALANCE PER COMPANY	EXAMINATION ADJUSTMENTS	BALANCE PER EXAMINATION	Notes
<u>ASSETS</u>				
Bonds	\$190,545,576	(\$389,461)	\$190,156,115	1
Common stocks	87,815,445		87,815,445	2
Mortgage loans on real estate				
Properties occupied by the company	24,934,737		24,934,737	3
Other properties	5,517,076		5,517,076	3
Cash and short-term investments	5,832,524		5,832,524	4
Aggregate write-ins for invested assets	73,005		73,005	5
Agents' balances or uncollected premiums:				
Premiums in course of collection less ceded reinsurance	9,806,347		9,806,347	6
Premiums booked but deferred and not yet due	42,056,259		42,056,259	6
Reinsurance recoverable on loss & loss adj. expense pmts.	36,391		36,391	
Federal income tax recoverable	3,844,108		3,844,108	7
Interest, dividends and real estate income due and accrued	2,684,551		2,684,551	
Receivable from parent, subsidiaries and affiliates	5,253,850		5,253,850	8
Aggregate write-ins for other than invested assets	76,152		76,152	
Total Assets	<u>\$378,476,022</u>	<u>(\$389,461)</u>	<u>\$378,086,561</u>	
<u>LIABILITIES</u>				
Losses	\$81,344,970		\$81,344,970	9
Loss adjustment expenses	19,779,344		19,779,344	9
Contingent commissions and other charges	973,038		973,038	
Other expenses (excluding taxes, licenses & fees)	5,640,950		5,640,950	
Taxes, licenses & fees (excl. fed. inc. tax)	396,665		396,665	
Fed. and foreign inc. taxes (excl. def. taxes)	194,746		194,746	7
Unearned premiums	103,111,128		103,111,128	10
Amounts withheld by company for others	17,818		17,818	
Excess of statutory reserves over statement reserves	116,248		116,248	
Drafts outstanding	6,329,757		6,329,757	
Payable to parent, subsidiaries and affiliates	1,397,089		1,397,089	8
Aggregate write-ins for liabilities	690,071		690,071	
Total liabilities	<u>219,991,825</u>		<u>219,991,825</u>	
<u>SURPLUS AND OTHER FUNDS</u>				
Unassigned funds (surplus)	158,484,194	(\$389,461)	158,094,733	
Surplus as regards policyholders	158,484,194	(389,461)	158,094,733	
Total liabilities, surplus and other funds	<u>\$378,476,019</u>	<u>(\$389,461)</u>	<u>\$378,086,558</u>	

PEMCO MUTUAL INSURANCE COMPANY
COMPARATIVE BALANCE SHEET
AS OF DECEMBER 31,

	<u>1998</u>	<u>1997</u>
<u>ASSETS</u>		
Bonds	\$190,156,115 *	\$183,177,835
Common stocks	87,815,445	78,445,153
Mortgage loans on real estate		
Properties occupied by the company	24,934,737	25,834,300
Other properties	5,517,076	5,792,098
Cash and short-term investments	5,832,524	7,397,435
Aggregate write-ins for invested assets	73,005	2,052,018
Agents' balances or uncollected premiums:		
Premiums in course of collection less ceded reinsurance	9,806,347	5,542,340
Premiums booked but deferred and not yet due	42,056,259	46,203,204
Reinsurance recoverable on loss & loss adj. expense pmts.	36,391	1,281
Federal income tax recoverable	3,844,108	613,460
Interest, dividends and real estate income due and accrued	2,684,551	2,534,304
Receivable from parent, subsidiaries and affiliates	5,253,850	2,886,119
Aggregate write-ins for other than invested assets	76,152	83,792
	<u>\$378,086,561</u>	<u>\$360,563,339</u>
<u>LIABILITIES</u>		
Losses	\$81,344,970	\$85,036,174
Loss adjustment expenses	19,779,344	16,997,105
Contingent commissions and other charges	973,038	943,802
Other expenses (excluding taxes, licenses & fees)	5,640,950	5,660,848
Taxes, licenses & fees (excl. fed. inc. tax)	396,665	476,018
Fed. and foreign inc. taxes (excl. def. taxes)	194,746	
Unearned premiums	103,111,128	98,953,233
Amounts withheld by company for others	17,818	5,055
Excess of statutory reserves over statement reserves	116,248	143,803
Drafts outstanding	6,329,757	5,993,639
Payable to parent, subsidiaries and affiliates	1,397,089	2,218,896
Aggregate write-ins for liabilities	690,071	611,890
Total liabilities	<u>219,991,825</u>	<u>217,040,463</u>
<u>SURPLUS AND OTHER FUNDS</u>		
Unassigned funds (surplus)	158,094,733 *	143,522,876
Surplus as regards policyholders	158,094,733	143,522,876
Total liabilities, surplus and other funds	<u>\$378,086,558</u>	<u>\$360,563,339</u>

* Balance adjusted per examination

PEMCO MUTUAL INSURANCE COMPANY

STATEMENT OF INCOME AS OF DECEMBER 31, 1998

	BALANCE PER COMPANY	EXAMINATION ADJUSTMENTS	BALANCE PER EXAMINATION	Notes
<u>UNDERWRITING INCOME</u>				
Premiums earned	\$195,104,789		\$195,104,789	
DEDUCTIONS:				
Losses incurred	119,178,066		119,178,066	
Loss expenses incurred	32,701,482		32,701,482	
Other underwriting expenses incurred	54,535,313		54,535,313	
Total underwriting deductions	206,414,861		206,414,861	
Net underwriting gain or (loss)	(11,310,072)		(11,310,072)	
<u>INVESTMENT INCOME</u>				
Net Investment Income earned	13,689,354		13,689,354	
Net realized capital gains or (losses)	3,161,386		3,161,386	
Net investment income gain or (loss)	16,850,740		16,850,740	
Net income before federal and foreign income taxes	5,540,668		5,540,668	
Federal and foreign income taxes incurred	727,201		727,201	
Net income	\$4,813,467		\$4,813,467	

PEMCO MUTUAL INSURANCE COMPANY
COMPARATIVE STATEMENT OF INCOME
FOR THE YEARS ENDED DECEMBER 31,

	<u>1998</u>	<u>1997</u>
<u>UNDERWRITING INCOME</u>		
Premiums earned	\$195,104,789	\$186,861,070
DEDUCTIONS:		
Losses incurred	119,178,066	129,341,780
Loss expenses incurred	32,701,482	24,431,913
Other underwriting expenses incurred	54,535,313	55,281,364
Total underwriting deductions	206,414,861	209,055,057
Net underwriting gain or (loss)	(11,310,072)	(22,193,987)
<u>INVESTMENT INCOME</u>		
Net Investment Income earned	13,689,354	13,084,025
Net realized capital gains or (losses)	3,161,386	5,867,181
Net investment income gain or (loss)	16,850,740	18,951,206
Net income before federal and foreign income taxes	5,540,668	(3,224,486)
Federal and foreign income taxes incurred	727,201	(561,584)
Net income	\$4,813,467	(\$2,662,902)

PEMCO MUTUAL INSURANCE COMPANY
CAPITAL AND SURPLUS ACCOUNT
AS OF DECEMBER 31, 1998

	<u>BALANCE PER COMPANY</u>	<u>EXAMINATION ADJUSTMENTS</u>	<u>BALANCE PER EXAMINATION</u>	<u>Notes</u>
Surplus as regards policyholders, December 31, previous year	<u>\$143,522,876</u>		<u>\$143,522,876</u>	
<u>GAINS AND (LOSSES) IN SURPLUS</u>				
Net income	4,813,467		4,813,467	
Net unrealized capital gains or (losses)	10,041,281		10,041,281	
Change in non-admitted assets	79,015		79,015	
Change in excess of statutory reserves over statement reserves	27,555		27,555	
1998 Examination adjustments to surplus		<u>(\$389,461)</u>	<u>(389,461)</u>	1
Changes in surplus	<u>14,961,318</u>	<u>(389,461)</u>	<u>14,571,857</u>	
Surplus as regards policyholders, December 31, current year	<u><u>\$158,484,194</u></u>	<u><u>(\$389,461)</u></u>	<u><u>\$158,094,733</u></u>	

COMPARATIVE CAPITAL AND SURPLUS ACCOUNT
AS OF DECEMBER 31,

	<u>1998</u>	<u>1997</u>	<u>1996</u>	<u>1995</u>	<u>1994</u>
Surplus as regards policyholders, December 31, previous year	<u>\$143,522,874</u>	<u>\$138,114,161</u>	<u>\$145,596,649</u>	<u>\$129,556,357</u>	<u>\$113,190,863</u>
<u>GAINS AND (LOSSES) IN SURPLUS</u>					
Net income	4,813,467	(2,662,902)	(7,687,231)	3,800,992	13,214,147
Net unrealized capital gains or (losses)	10,041,281	5,175,315	2,520,684	12,214,241	2,292,082
Change in non-admitted assets	79,015	2,770,323	(2,713,323)	(77,143)	(23,544)
Change in excess of statutory reserves over statement reserves	27,555	147,998	15,781	94,702	(140,022)
1998 Examination adjustments to surplus	(389,461)				
Extraordinary amounts of taxes for prior years			249,307	(91,717)	575,770
Miscellaneous surplus adjustment		(22,021)	132,294	99,217	447,061
Changes in surplus	<u>14,571,857</u>	<u>5,408,713</u>	<u>(7,482,488)</u>	<u>16,040,292</u>	<u>16,365,494</u>
Surplus as regards policyholders, December 31, current year	<u><u>\$158,094,733</u></u>	<u><u>\$143,522,874</u></u>	<u><u>\$138,114,161</u></u>	<u><u>\$145,596,649</u></u>	<u><u>\$129,556,357</u></u>

PEMCO MUTUAL INSURANCE COMPANY
ANALYSIS OF EXAMINATION CHANGES IN FINANCIAL STATEMENTS
AS OF DECEMBER 31, 1998

	Increase (Decrease)	<u>Notes</u>
Surplus as regards policyholders, per company	\$158,484,194	
<u>ASSETS</u>		
Bonds	(389,461)	1
	<hr/>	
Net Increase/(Decrease) to surplus	<hr/> (389,461)	
Surplus as regards policyholders, per examination	<hr/> <hr/> \$158,094,733	

NOTES AND COMMENTS TO FINANCIAL STATEMENTS

1. **BONDS** represent 50.345% of Total Assets and 120.230% of Total Surplus. With the exception of one \$5,000 bond, bonds are stated at amortized cost and all are investment grade bonds with a SVO rating of 1 or 2. Amortized cost is computed using the effective interest method. Investment grade loan-backed bonds and structured securities are reported at amortized cost using the interest method including anticipated prepayments at the date of purchase.

The Company filed all bonds with the Securities Valuation Office (SVO) when not previously listed. One bond was not yet listed by the SVO and should have been noted on the 1998 Schedule D with a "Z" rating as required by the APPM. (see Instruction # 2)

The examination adjustment in the amount of \$389,461 represents bonds held by US Bank Corporate Trust according to a special escrow agreement between PEMCO Corporation and the Washington State Department of Labor and Industries. This amount is non-admitted because RCW 48.12.010 requires all investments are to be held in the insurer's name. This was corrected July 1, 2000. (see Instruction # 3)

2. **COMMON STOCKS** represent 23.202% of Total Assets and 55.410% of Total Surplus. Common stocks are reported at market value. The Company investment in PEMCO Insurance Company (100%) is reported at its cost adjusted to reflect its equity in the subsidiary's subsequent statutory earnings as described in Section 3 Part 8 of the Purposes and Procedures of the Securities Valuation Office of the NAIC. The Company's investment in Evergreen Bank (3.3%) is reported at market value. The Company's investment in PEMCO Corporation (26%) is non-admitted by the Company because the market value is difficult to establish.
3. **REAL ESTATE (Occupied)** represents 6.588% of Total Assets and 15.733% of Total Surplus. **REAL ESTATE (Other)** represents 1.458% of Total Assets and 3.481% of Total Surplus. All real estate is reported at book value which is cost less accumulated depreciation. Depreciation is computed using the straight line method over the useful lives of the buildings. There were no purchases during the examination period. There was one sale of vacant land located in Pierce County, Washington during 1998. The Board of Directors did not note their approval of that transaction in its meeting minutes as required by RCW 48.13.340 and 350. (see Instruction # 4)
4. **CASH AND SHORT TERM INVESTMENTS** are 1.541% of Total Assets and 3.680 % of Surplus. The balance consists of \$1,447,524 in cash and \$4,385,000 in two money market mutual funds and two repurchase agreements all purchased during December 1998. All are SVO class "1" issues. These were all valued at cost in accordance with the NAIC Valuations of Securities manual and the applicable section of the Washington Insurance Code.
5. **AGGREGATE WRITE-INS FOR INVESTED ASSETS** are annual income certificates which are demand savings accounts offered to Washington residents and PEMCO affiliated company employees by PEMCO Corporation. The method of valuation and classification of these certificates was discussed among the Company, the OIC financial examiner and the OIC financial analyst after which it was decided that the certificates should be filed and rated by the SVO. The Company chose instead to dispose of nearly \$2,000,000 in annual

income certificates during 1998 and the remaining balance in the amount of \$73,005 was disposed of during 1999. The Company no longer invests in annual income certificates.

The Company also owns 47,401 shares of \$1 par value common capital stock or 26% of PEMCO Corporation which is classified in this category. The Company values this stock at a market value of \$869,000 on a GAAP basis. The method of valuation and classification of this investment was also discussed with the Company, but the Company has chosen a conservative valuation and non-admitted the entire value on a Statutory basis.

- 6. AGENTS BALANCES OR UNCOLLECTED PREMIUMS** are 13.703% of Total Assets and 32.725% Surplus. The Company has a general agent agreement that became effective in 1959 with an affiliated company, Public Employees Insurance Agency (the Agency). That agreement provides for premium collection services to be provided by the Agency. The Agency pays PMIC periodically based upon the installment due dates which creates a situation wherein there are never any overdue balances.

The Company changed the accounting method used to account for premiums over 90 days receivable for 1998. This change reflects aging of the receivable based on the due date of the installment. In the past, premiums were aged based on the anniversary date of the policy. The result of this change brought the December 31, 1997 premiums over 90 days receivable to zero. The Washington State Insurance Commissioner approved the change and prior year balances were not restated.

- 7. FEDERAL INCOME TAX RECOVERABLE/PAYABLE** are 1.016% and 0.051% of Total Assets respectively. The Company files a consolidated return with its wholly owned subsidiary, PEMCO Insurance Company. The method of allocation between the companies is subject to an agreement approved by the Board of Directors. Allocation is based upon separate return calculations with current credit for net losses.

All tax payments are made to the IRS through PMIC. PIC records its portion of the estimated tax liability for each month through the inter-company receivable from/payable to account. These balances are settled within fifteen business days after the affiliated companies have closed the books for the month. The final inter-company tax balances are settled annually in the filing quarter when the final liability is determined.

- 8. RECEIVABLE/PAYABLE FROM PARENT, SUBSIDIARIES AND AFFILIATES** are 1.388% and 0.369% of Total Assets respectively. The affiliated companies have extensive cost sharing activities among themselves. PEMCO Mutual Insurance Company owns the real estate occupied by the affiliated companies and leases specified space to the affiliated companies per periodic amendments to the Agreement of Lease. PMIC from time to time also procures products, supplies and services on behalf of the affiliated companies. Inter-company account balances are generally satisfied within fifteen days after month end closing. Refer to "Cost Sharing Agreements" in this report for more discussion.

- 9. UNPAID LOSSES AND UNPAID LOSS ADJUSTMENT EXPENSES** are respectively 21.493% and 5.226% of Total Assets and 51.327% and 12.480% of Surplus.

- 10. UNEARNED PREMIUMS** are 27.244% of Total Assets and 65.061% of Surplus.

ACKNOWLEDGMENT

The cooperation extended to the examiners by the officers and employees of the Company during the course of this examination is hereby acknowledged.

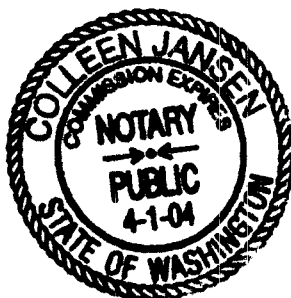
In addition to Larry A. Omdal, Examiner in Charge, Constantine Arustamian, CPA, John R. Jacobson, AFE, IS Specialist, Peter M. Mendoza, CFE, CIE and D. Lee Barclay, FCAS, MAAA, Senior Actuary and James Antush, Actuarial Analyst 2, all from the Office of Insurance Commissioner, State of Washington, participated in the examination and preparation of this report.

State of Washington)
) ss.
County of King)

Larry A. Omdal, being duly sworn, deposes and says that the foregoing report subscribed by him is true to the best of his knowledge and belief.

Larry A. Omdal
Larry A. Omdal
Examiner in Charge

Subscribed and sworn to before me on this 24th day of October, 2002.



Colleen Jansen
Notary Public in and for the
State of Washington,
residing at Seattle